

**Do You Have to Disclose a Government Investigation?
Practical Considerations, Legal Standards, and Recent Case Law**

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Speed Read

When a public company is under government investigation, there is no bright line standard for whether or when disclosure is required. In many cases, disclosure is not automatic. Companies under investigation or inquiry should consult outside counsel, review D&O insurance coverage and continue reevaluating the status of the investigation to determine whether any disclosure obligations have arisen.

After receiving an inquiry from a government agency, such as a subpoena, a Civil Investigative Demand (“CID”), or an informal request for information, public companies ask whether they must disclose publicly that they may be under investigation. A corollary question to public disclosure is how broadly to disclose internally, to lenders, or to D&O insurers.

The standards for disclosing government investigations are not straightforward, due in part to an absence of cases and SEC interpretive guidance providing meaningful direction on this topic under the securities laws. As a result, disclosure practices vary. Companies sometimes disclose investigations upon receipt of a subpoena or CID, some wait until an intermediate stage after the investigation progresses, and some wait until the SEC advises the company that it tentatively decided to recommend an enforcement action by sending the company a “Wells” notice¹ or until the investigation

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¹ Under Section 2.4 of the SEC’s current Enforcement Manual and as part of long-standing SEC practice, the SEC’s staff may, but is not required to, send a letter to the company or individual providing notice of a decision by the staff to recommend to the Commission that an enforcement case be filed. This letter is known as a “Wells Notice.”

is otherwise nearing conclusion. However, a few recent cases out of federal courts in the Southern District of New York and the Court of Appeals for the Ninth Circuit in California provide some additional guidance for companies navigating this issue.

For public companies, it is important to understand that disclosure is generally not automatic. While there are some circumstances where a company must disclose an investigation promptly, other circumstances may be less clear and it may be in the company’s best interest not to publicly disclose this information until a later time, if at all. With the assistance of counsel, companies should carefully consider their own unique facts and circumstances to reach a judgment as to their disclosure obligations.

**Practical Reasons for Disclosing
or Not Disclosing an Investigation**

There are practical reasons that may cause companies to disclose investigations even when a particular rule or regulation does not require immediate disclosure.

First, a company may feel pressure to disclose due to certain business relationships or obligations. For example, the company’s auditors may strongly encourage the company to disclose the investigation, leading the company to do so to avoid tense conversations or potential delays in SEC filings. Additionally, a company may have contractual agreements requiring it to disclose a government investigation to lenders or others, which may create concerns about issues related to selective disclosure under SEC Regulation Fair Disclosure, often referred to as “Reg. FD.” In other cases, a company may have an M&A deal pending and choose to disclose to give shareholders a better understanding of the transaction and the sale price. Finally, a company may decide to disclose in order to ensure that the company or insiders who are aware of the investigation may trade their company stock without concern that the investigation may constitute

material nonpublic information that would prevent those insiders from trading.

Second, a company may decide to disclose a government investigation to address concerns regarding potential negative reactions if the investigation is likely to be disclosed later. Companies may worry that if they do not disclose the investigation at the outset, shareholders, analysts, rating agencies, institutional investors, and others (including shareholder plaintiffs' lawyers) will react poorly if they learn of the investigation later. There may also be a concern that third parties may leak news about the investigation—for example, persons who are not the subject of the investigation but who receive subpoenas. If an investigation does get leaked, even the slightest rumors can lead to questions about whether the company is a target of an investigation. A company may prefer to respond substantively to these inquiries rather than with a “no comment” answer in order to avoid even more speculation. News or rumors of pending investigations may also be leaked by organizations that specialize in mass FOIA requests. Most companies prefer to be the source of information about an investigation, rather than having that information reach the public via third parties, so that it has the ability to shape the messaging and ensure that the information is fulsome and accurate.

At the same time, companies should consider the costs of early disclosure. Shareholders may give an investigation greater weight than is merited because they are generally not in a position to distinguish between investigations resulting from indications of actual malfeasance and investigations that are more akin to fishing expeditions. In this same vein, the mere fact that the company discloses an investigation may be misunderstood by some shareholders as indicating that the company engaged in wrongdoing, which, among other things, may lead to baseless lawsuits and/or books and records demands by shareholders. In addition, early disclosure of an investigation may actually put more pressure on regulators to ultimately bring an enforcement action against the company.

Thus, practical considerations often point in conflicting directions and it is important to evaluate the specific facts of each scenario and understand the applicable legal disclosure obligations.

Consider the Type of Government Request and the Stage of the Investigation

Before disclosing any developments related to an investigation, the company should consider the type of government inquiry received, the stage of the investigation, the potential impact of the investigation on the company, and any other relevant facts. For example, if a company receives a Wells Notice indicating that it is the target of a government investigation that may result in a large penalty or settlement, the company will usually conclude that it should disclose receipt of the Wells Notice. Conversely, if the SEC issues a subpoena seeking information pertaining to a third party, a company will usually conclude that disclosure is not required. In other cases, however, the circumstances of a government investigation are not this cut and dry and the company cannot assess the scope or potential impact until it has conducted its own investigation into the matter. In many cases, it is prudent to delay disclosure at least until the company has a more complete understanding of the potential implications and costs of the government inquiry.

A company should keep in mind that a government investigation, whether formal or informal and whether involving a voluntary request for information, a subpoena, or a CID, is a fact-finding exercise. It is not a determination that any person or entity has violated the law; rather, it is designed to gather those facts necessary for an agency to make an informed decision about whether violations of law have occurred and whether an enforcement action is warranted.²

These fact-finding exercises can in some cases take years to complete. Early disclosure by a company may create a situation in which the company has an ongoing legal or practical duty to provide updates about the investigation in its SEC filings and at other times and by other means that satisfy

² As the SEC states in the standard disclosures contained in its subpoenas: “This investigation is a non-public, fact-finding inquiry. We are trying to determine whether there have been any violations of the federal securities laws. The investigation and the subpoena do not mean that we have concluded that you or anyone else has broken the law. Also, the investigation does not mean that we have a negative opinion of any person, entity or security.” Similarly, 12 U.S.C. § 5562(c) provides that the Consumer Financial Protection Bureau, like many other federal agencies, may issue a CID when it has reason to believe that a person “may” have information relevant to a violation.

other potential disclosure requirements (such as stock exchange listing requirements) and comply with Reg. FD.

Rules and Regulations Governing Disclosure Obligations

The securities laws require disclosure: (1) when an affirmative duty to disclose arises under applicable rules or regulations; or (2) when failing to disclose it would render other disclosures misleading.³ The disclosure rules most commonly considered when evaluating whether to disclose a government investigation are SEC Regulation S-K, Items 103 and 303. In the absence of other triggers (such as filing a registration statement or purchases or sales of company securities by the company or an affiliate of the company), both of these disclosure items are required in quarterly reports on Form 10-Q and annual reports on Form 10-K filed by domestic public companies. Companies must also consider additional disclosure obligations set forth by the New York Stock Exchange and Nasdaq Stock Exchange.

Item 103, titled “Legal Proceedings,” sets forth the types of legal proceedings a public company is required to publicly disclose. Item 103 generally requires companies to disclose “material” pending legal proceedings, which requires review of the relevant facts and circumstances. Item 103 also provides a disclosure threshold for pending proceedings for which the amount involved, exclusive of interest and costs, does not exceed 10% of the company’s consolidated current assets. Companies must aggregate similar legal proceedings, both pending and known to be contemplated, in calculating whether legal proceedings exceed this 10% amount. For purposes of Item 103 (but not Item 303, discussed below), companies should balance the probability that a loss will be incurred and the anticipated magnitude of those losses.

Item 103 also requires companies to “describe any material pending legal proceeding ... known to be contemplated by government authorities.” If

³ Section 10(b), SEC Rules 10b-5, and 12b-20 of the Securities Exchange Act of 1934; and Section 11 and Rule 408 of Regulation C of the Securities Act of 1933 provide that companies may not omit material facts necessary to make the statements that they make “not misleading.” Whether a company misleads by not disclosing an investigation depends on what other affirmative statements it has made and needs to be evaluated as a whole with all other information that is available to the market.

governmental authorities inform a company that they are likely to commence a civil or criminal proceeding, Item 103 requires the company to disclose the potential proceeding if it is material.

Because governmental investigations typically precede any of the disclosure requirements of Item 103, companies often do not disclose the existence of an investigation under Item 103.

Item 303, titled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD&A”), may also require companies to disclose information related to threatened or pending litigation. Item 303 requires public companies to disclose in MD&A “any known trends or uncertainties that have had or that the company reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.” Item 303 specifically requires that “[t]he discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition,” including “descriptions and amounts of...matters that would have an impact on future operations and have not had an impact in the past... .” Although governmental investigations do not often trigger MD&A disclosure, plaintiffs’ lawyers frequently claim that Item 303 requires a company to disclose an investigation if it “reasonably expects” the investigation will have a material adverse effect on the company.

Companies should work with their advisors in making these determinations and should also consider the interpretive guidance in SEC Staff Accounting Bulletin No. 99, which states that materiality cannot be determined solely on the basis of quantitative measures (such as the potential dollar amount involved), but requires analysis of a variety of other qualitative factors.

Accounting Considerations. It is also important to consider internally, and in discussions with auditors, the potential application of *Accounting Standards Codification (“ASC”) 450* when considering disclosure obligations. ASC 450 addresses, among other things, disclosure requirements for “loss contingencies,” including disclosure of both asserted and unasserted claims. With respect to

unasserted claims, ASC 450 states that disclosure is required if there has been a “manifestation by a potential claimant of an awareness of a possible claim” and the claim is at least “reasonably possible.” ASC 450 does not state whether the commencement of an investigation is a manifestation of awareness of a possible claim.

ASC 450 also states that in the absence of a manifestation by a potential claimant of awareness of a possible claim, disclosure of an unasserted claim is still required if it is “probable” that the claim will be asserted and there is a reasonable possibility the outcome will be unfavorable. The mere fact that an investigation has been commenced does not mean that it is probable that a claim will be asserted or that, if it is, there is a reasonable possibility that the outcome will be unfavorable. Nonetheless, if the company and its auditors conclude that the company must disclose the investigation per ASC 450 as a footnote regarding loss contingency and/or establish a reserve for it, that decision will usually support disclosure elsewhere in a filing, such as in the legal proceedings sections of a Form 10-Q or 10-K.

Differences Among Item 103, Item 303 and Accounting Disclosures. Although the disclosures required by Item 103, Item 303 and ASC 450 may overlap to some extent, they are not identical. If a company chooses to address these requirements with a single set of disclosures, it should ensure that its disclosures satisfy all applicable requirements. For example, Item 103 requires principally descriptive disclosure. Item 303 requires some analysis of the likelihood of an adverse outcome and its potential amount, as well as the potential effect on the company’s income statement and balance sheet items. ASC 450 requires a different and more technical assessment of potential probabilities and outcomes than Item 303.

Recent Case Law Interpreting These Disclosure Standards

Two recent cases provide important disclosure guidance for public companies facing government inquiries.

On January 22, 2016, the Southern District of New York dismissed *In re Lions Gate Entertainment Corp. Securities Litigation*, a shareholder class action against the movie studio Lions Gate. The district court held that there is no general obligation under

the federal securities laws to disclose to investors an ongoing SEC investigation or even the receipt of a Wells Notice and that these developments were not *per se* material to investors. As the court explained, after issuing a Wells Notice, the SEC Enforcement Division may choose not to proceed with a recommendation to commence an action and, even if the SEC staff does recommend enforcement action, the SEC may decide not to authorize filing of an action. Therefore, the court held, “the defendants did not have a duty to disclose the SEC investigation and Wells Notices because the securities laws do not impose an obligation on a company to predict the outcome of investigations. There is no duty to disclose litigation that is not ‘substantially certain to occur.’”

The court also rejected plaintiffs’ argument that Lions Gate had a duty to disclose the existence of the regulatory investigation because it could have affected the company’s financial condition due to the potential for a material penalty. In this case, the court observed that the \$7.5 million civil penalty ultimately imposed on it by the SEC was less than one percent of Lions Gate’s consolidated revenue of \$839.9 million for the third quarter of 2014, and well below the five percent numerical threshold that the Second Circuit has determined is a “good starting place for assessing the materiality of the alleged misstatement.” The court further explained that the “possibility of materiality” is not enough to support a securities fraud claim.

In addition, the court rejected plaintiffs’ argument that that company had a duty to disclose the investigation under SEC Regulation S-K, Items 103 and 303. The court held that an SEC investigation itself is not a “pending legal proceeding” for purpose of Item 103, nor is it an indication that the government is “contemplating” a proceeding, because the SEC had not yet decided whether to bring a case. The court held that based on the facts of that case, the SEC investigation was not indicative of any trend or uncertainty reasonably likely to have a material impact on the company’s financial condition or results of operations for purposes of Item 303.

In addition to *Lions Gate*, the Ninth Circuit’s February 1, 2016 decision in *Lloyd v. CVB Financial Corporation* may influence companies’ decisions whether or not to disclose government

investigations, because such disclosures could make it more difficult for companies to defend themselves against subsequent claims of violations of the federal securities laws. In that case, CVB made representations in SEC filings that there was no basis for “serious doubt” about the ability of its largest borrower to repay loans received from CVB. The SEC later served a subpoena on CVB, seeking information about its loan underwriting methodology and allowance for credit losses. CVB announced receipt of the subpoena and the very next day its stock dropped 22%. Analysts speculated that the subpoena was likely related to CVB’s loans to that large borrower. A month later, CVB announced that the borrower could not repay its debt and, as a result, it had to write down \$34 million in loans and place another \$48 million in its non-performing category. CVB’s stock price only dropped by a couple of cents after this announcement and quickly recovered. Ultimately, the SEC never instituted any formal proceedings against CVB.

Shareholders initiated a securities class action accusing CVB of issuing false statements about its exposure to these under-performing loans, which the district court dismissed. However, the Ninth Circuit reversed, reviving the case, holding that the disclosure of the SEC investigation, when taken together with a subsequent revelation that prior statements made by the company about the non-performing loans were inaccurate, could form the basis for a theory of loss causation, equating the announcement of the investigation to a “corrective disclosure.”

If CVB had chosen not to disclose the SEC investigation, the Ninth Circuit may have affirmed dismissal of this litigation for failing to plead loss causation because the company’s stock price barely reacted to the true “corrective disclosure” announcing the write off, providing yet another possible reason to refrain from disclosing investigations early in the process unless absolutely necessary.

Key Take-Aways

- Disclosure is in many cases not automatic. Rather, upon receipt of a government inquiry, companies should promptly contact outside counsel to help them carefully consider their own unique facts and circumstances to reach a judgment as to their disclosure obligations.
 - Upon receipt of notice of an investigation or similar proceeding, a company should review its D&O insurance coverage to determine if there are any provisions requiring its insurer to cover the legal costs associated with responding to the government. Internal disclosure should be made on an as needed basis, limiting the possibility of leaks.
 - Even if a company decides not to disclose an investigation in its early stages, the company should continue to reevaluate the status of the investigation from time to time as it progresses to determine if an obligation to disclose the investigation has arisen as the investigation progresses.
- There is generally no bright line standard for whether or when public companies must disclose government investigations. It is a fact specific inquiry with disclosure considerations arising from a variety of sources.